N EXPLORATION INC.

ANNUAL REPORT 1998

Annual Meeting

The Annual General Meeting of Devlan Exploration Inc. will be held on Wednesday, June 23rd, 1999 at 3:30 PM in the President's Room at the Calgary Petroleum Club at 319 - 5th Avenue SW, Calgary, Alberta.

DEVLAN EXPLORATION INC.

Devlan Exploration Inc. is an Alberta based junior natural gas producer that has historically concentrated on asset optimization and production enhancement. A major acquisition in late 1998 delivered multiple exploration opportunities that Devlan will pursue as the Company moves to the next stage of its growth.

Management is committed to a strategy of balanced growth. This strategy obliges Devlan to manage its business as a portfolio. Corporate growth is fueled by acquisition opportunities and through the drill bit, prospect inventory includes both oil and natural gas. Finally, drilling activity is balanced between development and exploration.

Devlan has consistently generated year over year production and reserve additions. Going forward, management's goal is to translate this asset growth into sustainable cash flow and earnings growth.

Devlan's common shares trade on the Alberta Stock Exchange under the symbol "DXI".

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ANNUAL REPORT 1998

1998 Summary

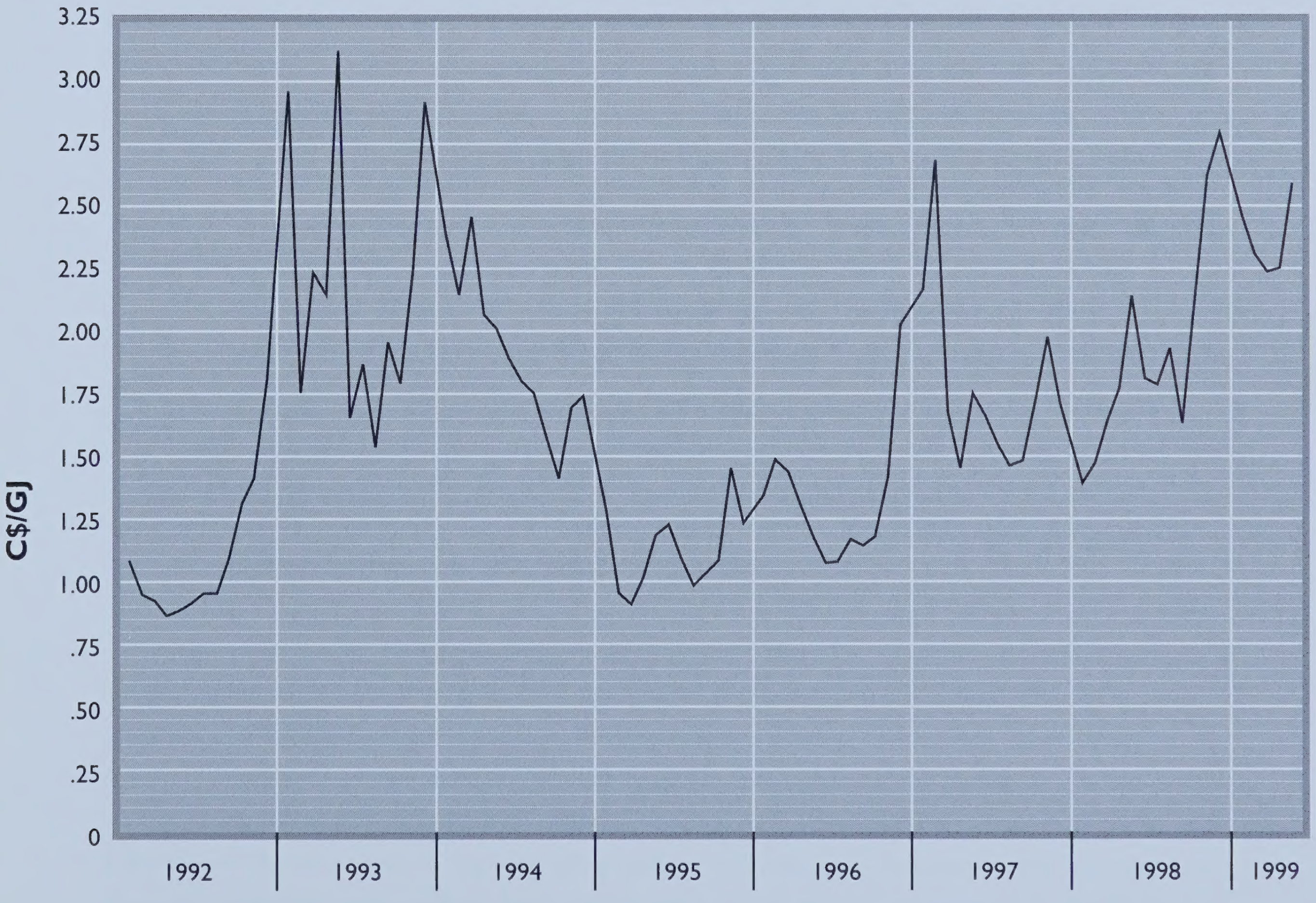
	Year ended Dec 31/98	12 months ended [1] Dec 31/97	% change
Financial			
Sales revenue (000's)	$1,299	$749	73%
Cash Flow (000's)	$259	$186	40%
CFPS (fully diluted)	5.8¢	4.5¢	
Earnings (Loss) (000's)	($140)	($65)	115%
EPS (fully diluted)	(3.2¢)	(1.6¢)	
Working Capital (deficiency) (000's)	($4,144)	($299)	1284%
Bank debt (000's)	($4,260)	($850)	401%
Related party transactions (000's)	($2,010)	—	
Capital lease obligations (000's)	($1,175)	—	
Debt: expected forward CF	2.32 X	3.47 X [2]	
Operations			
Exit Natural Gas Sales (mcfd)	3,700	1,341	176%
Average Daily Sales (mcfd)	1,700	1,350	26%
Average Sales Price (plantgate) (C$/mcf)	2.09	1.56	34%
Gross Company Reserves (mmcfe):			
proven	9,435	3,735	153%
probable	1,704	4,680	-64%
Total	11,139	8,415	32%
Gross Company Reserves (10%) (000's):			
proven	$9,782	$3,090	217%
probable	$1,318	$3,153	-58%
Total	$11,100	$6,243	78%
Land (net acres)	97,580	34,331	184%
Average working interest	92%	76%	20%
Capital expenditures (000's)	$8,482	$1,286	560%
Common shares outstanding			
Basic	5,488,905	4,389,485	
Fully diluted	5,863,905	4,815,951	
Common shares outstanding			
Weighted average (b)	4,432,990	3,913,506	
Weighted average (fd)	4,443,264	4,133,065	

Notes: [1] For comparison purposes the Company has prepared an unaudited 12 month period by adding first quarter of calendar 1997 to the audited 9 month stub period found in the Consolidated Financial Statements. [2] December 31, 1997 Debt to forward cashflow includes a $50,000 convertible debenture in the calculation.

Operationally, 1998 was another strong year for Devlan Exploration Inc. Once again, Devlan delivered sales, reserves and land base gains. Although the Company's fourth quarter activity had relatively little impact on the 1998 benchmarks, it positioned the Company for accelerated expansion. The Diamond City and Marten Hills acquisitions have proved pivotal already in 1999. We are proud of our accomplishments and, as we continue to build on the momentum established in late 1998, we are confident that our development plan for 1999 will deliver sustainable growth heading into the next millennium.

Alberta natural gas prices are at the highest sustained level since deregulation. Market fundamentals indicate that these price levels will continue and likely improve over the next 12 to 48 months as a result of increased export demand. Devlan's management believes this demand surplus will exist through 2003. Natural gas prices will continue to strengthen above these already historic highs and gas-weighted producers such as Devlan will reap the benefits.

Alberta Natural Gas Prices



Source: Dynegy Canada Inc.

Report to Shareholders

Devlan's Strategy

Devlan's management focus and financial resources were directed to acquisition and development of natural gas properties in 1998. **Our activities will remain primarily natural gas driven in 1999 and beyond.** At the same time, the Company will continue to assemble crude oil and liquids opportunities that will be developed when the market is right. Devlan's operating philosophy is defined by the following four key principles:

1) **Operate all properties**

Devlan has unparalleled upstream expertise and understanding. Control of operations ensures we directly manage costs, direction and pace of development.

2) **Concentrate**

The Company focuses on core areas where we have high working interest and operational control. Geologically, we concentrate on projects where we have a strong understanding and, as a result, Devlan consistently enhances newly acquired properties. As we add expertise and establish solid financial footing, the Company then takes on new challenges and opportunities.

3) **Maintain a very high working interest in all projects**

This increases the return on Devlan's competitive advantage - operational skill and ability. Devlan averages a 92% working interest on all properties.

4) **Manage risk - geological and commodity price**

Devlan strives to maintain the delicate balance between risk and reward. To date, the Company has specialized in shallow natural gas production; a relatively low risk enterprise. As cash flows increase, we will bring on high impact opportunities.

A certain portion of production will be hedged on a progressive basis as the market price reaches targets set by Devlan's management. Using sound risk management procedures, these price targets have been set to maximize asset appreciation and cash flow for further growth.

1998 Highlights

Devlan continued to grow in a sustainable and consistent manner in 1998. The Company increased sales volumes, reserves and land holdings. Financially, revenues were up 73% and cash flow increased by 40% over the comparable 12 month period ended December 31, 1997.

In the first quarter, Devlan completed the Highland Ranch well in Wyoming. With the subsequent meltdown of oil prices, the Company pulled back operations in Wyoming to focus on natural gas opportunities in Alberta. As oil prices continue to maintain a healthy level, Devlan will prudently revisit its Wyoming prospects.

During the second and third quarters of 1998, Devlan acquired a producing natural gas property adjacent to its existing Keho Lake field. This property, called Iron Springs, added 4,000 acres of undeveloped land and 755 mcfd of production.

In August, the Company completed a private placement of 104,084 common shares for gross proceeds of $124,900. Proceeds were used to acquire a further 10% interest in Keho Lake and Coaldale.

The fourth quarter was far and away the most active quarter for Devlan. In October, the Company acquired an optioned natural gas well and adjacent acreage. Immediately thereafter, Devlan drilled two wells into the Bow Island zone at 1,000 meters. Two wells were brought on stream in February 1999 and added a sustained 800 mcfd to Devlan's production.

On October 16th, Devlan received shareholder approval to consolidate its common share capital on a 1:4 basis (1 new share for every 4 old shares). This resulted in Devlan having 4,493,569 Common Shares issued and outstanding. In conjunction with the share consolidation, the ASE required that Devlan change its name and trading symbol so as to avoid confusion in the marketplace. As a result, the Company changed its name to DEVLAN EXPLORATION INC. and its trading symbol to DXI, effective November 3, 1998.

Also in November, Devlan sold its share of two gas plants and related facilities in Keho Lake and Coaldale for $1.2 million cash. The agreement provided Devlan with continued operatorship of the plants and facilities thereby keeping control of this very active area in Devlan's hands. We recorded the sale and leaseback arrangement as a capital lease, rather than an operating lease. Although capital lease transactions are reported on the balance sheet and considered debt, we believe this recording method will alleviate confusion in the marketplace. Financial recording issues aside, a lease obligation is an obligation, whether it be a capital lease, with payments booked as DD&A, or an operating lease, with payments booked as operating expenses.

Report to Shareholders

In December, Devlan acquired a property in the Marten Hills area of north central Alberta for $5.175 million. Devlan Marten Hills included 54,952 net acres of multi-zone natural gas prospects and 1,700 mcfd net sales gas. Proven Gross Company Reserves at Marten Hills as reported by Sproule Associates were 5.128 Bcf on December 1, 1998. Facilities include two identical dehydration/compression packages and 28 miles of gathering and sales pipeline. Subsequent to year-end, Devlan monetized these facilities for $3 million.

On December 31, 1998 Devlan closed two private placements for gross proceeds of $968,069. Total basic share capital as of December 31, 1998 was 5,488,905 shares outstanding. On a fully diluted basis Devlan exited 1998 with 5,863,905 shares outstanding.

Looking Ahead

Marten Hills will be the primary focus of Devlan's 1999/2000 capital expenditures. The Company will continue its development program, purchase and shoot seismic and begin its exploration program in 1999.

We will continue to develop our Lethbridge properties and, as opportunities arise to expand our presence, we will pursue them vigorously.

In Wyoming, Devlan will continue to evaluate the opportunities associated with Highland Ranch and Pinetree. These are high impact prospects with significant opportunities. It is Devlan's intention to capitalize on these opportunities. At the same time, we will manage the risks associated with these plays in a very prudent manner.

Devlan is forecasting cash flow of $3.2 million (51¢/share) in 1999 compared to $259,000 in 1998. The forecasted increase in cash flow will be achieved by increasing natural gas production. Exploration and development projects will be weighted towards natural gas in order to take advantage of the very bullish natural gas market fundamentals. 1999 natural gas prices are anticipated to equal Devlan's 1998 average plantgate price of $2.09/mcf. The Company plans to hedge a portion of its natural gas production in 1999. At December 31, 1998, the current portion of Devlan's long term debt was $1.76 million. This obligation will be serviced with the forecasted cash flow.

Report to Shareholders

Public companies such as Devlan have a responsibility to convey information to stakeholders in a straightforward manner. Devlan delivers information to the marketplace in *black & white*. That is, we strive to take away the ambiguity so the company's performance can be analyzed in a definitive manner. The most critical data is reported as follows:

- Devlan reports sales volumes.
- Leases are recorded as capital leases, on the balance sheet.
- Land holdings are net to the Company.
- Cash flow equals earnings plus depreciation and amortization.

This 1998 annual report represents our dedication to clear and candid reporting.

We would like to take this opportunity to acknowledge the support of our shareholders and thank our Board of Directors for their counsel and guidance throughout the year.

Martin J. Cheyne
President & CEO
May 20, 1999

1999 Focus

Devlan Marten Hills

The acquisition of Marten Hills gives Devlan a large contiguous land block to explore and creates a new core area for the Company. The bulk of Devlan's 1999 capital expenditure program is directed to development and exploration of this property.

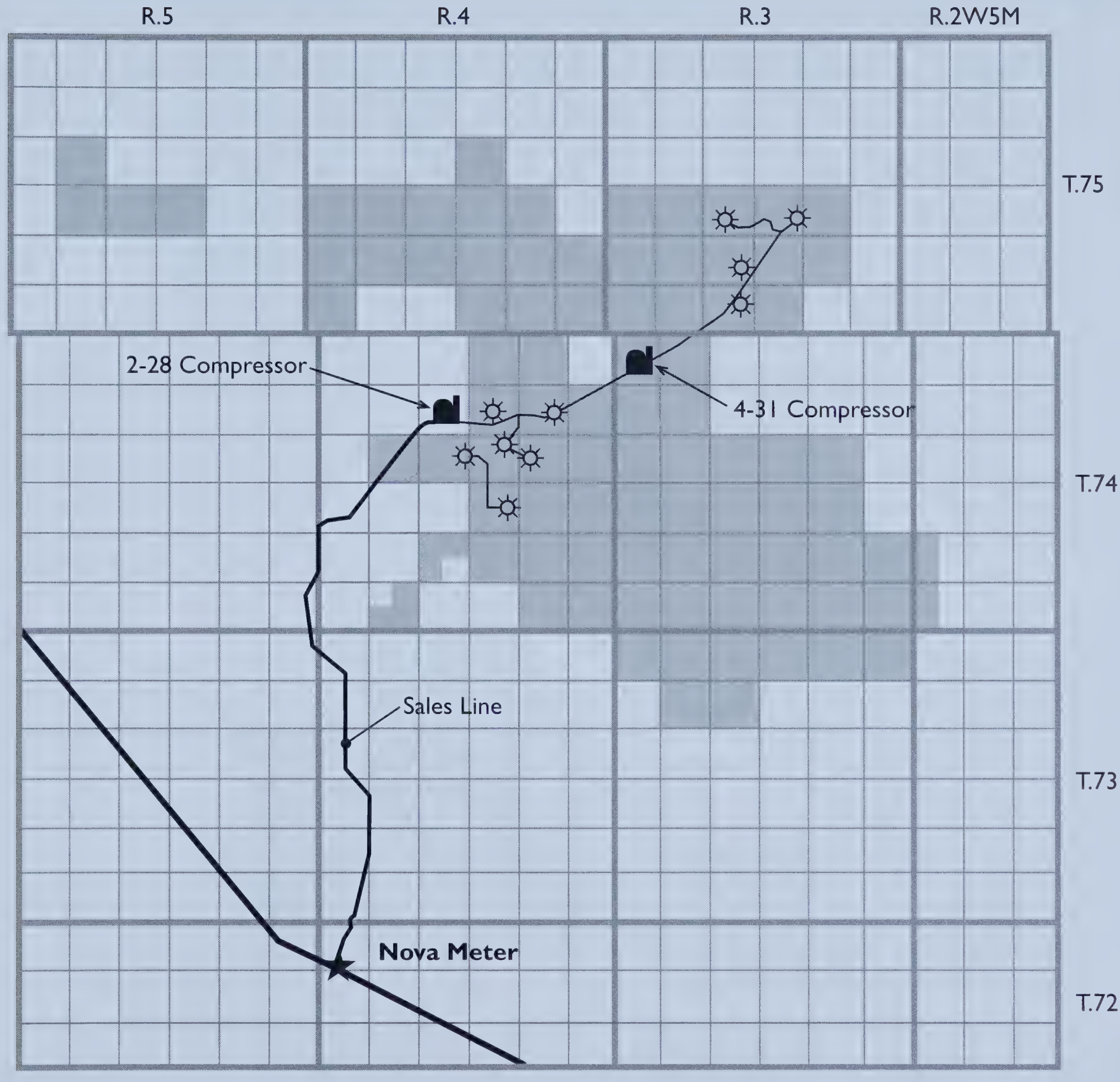
Natural gas is produced from the Cretaceous Wabiskaw, Clearwater, Sparky, Colony and Viking Formations. These shallow marine sandstone deposits are widespread throughout the lands. Reservoir accumulations occur when the sands are draped over Mississippian topographic highs, creating structural traps. Porosity and permeability are in the range of 30 to 36% and 500 - 1000 millidarcies. Devlan has purchased 57 km of 2-D seismic data and identified six prospects that will be drilled in 1999 and 2000. Seismic has also identified shallow Belly River anomalies. Further seismic work will continue to proceed as needed. The multi-zone nature of the area allows for individual wells to produce 4 or 5 Bcf. The potential for stacked pays at drilling depths of only 700 to 900 meters renders Marten Hills an ideal exploration area for Devlan. Drilling costs are estimated to be $150,000 per well drilled and cased and $200,000 tied in.

During the first quarter of 1999, Devlan tripled net production through strategic optimization of the existing facilities, including workovers and operational enhancement. Further development work is being planned in two wells where perforating uphole zones will add another 2,000 to 3,000 mcfd.

On April 9, 1999 Devlan monetized the two natural gas compressor stations and 28 miles of pipeline in Marten Hills for $3 million. The key component of the transaction is Devlan's continued operation of the facilities. This allows Devlan to control the area. Marten Hills is a key component of Devlan's growth over the next 3 to 4 years and the Company is not prepared to give up control of the infrastructure.

Devlan used $2 million of the proceeds to pay down the debt associated with the purchase of Marten Hills. $1 million is being applied directly to exploration and development of Marten Hills.

Devlan Marten Hills



1998 Operations Review

Devlan's Canadian activities are focused on shallow gas properties - Marten Hills (purchased in December 1998) and Lethbridge in Southern Alberta. The Lethbridge properties include Keho Lake/Iron Springs, Diamond City and Coaldale.

Keho Lake/Iron Springs

Keho Lake produces from the Bow Island Formation at depths of only 1,000 meters. During 1998, Devlan expanded its position in the area by acquiring 5,873 acres, bringing total land holdings in Keho Lake/Iron Springs to 14,901 net acres. Sales from the area as of December 31, 1998 were 1,108 mcfd. Proven reserves as of December 1, 1998 were 1.9 Bcf.

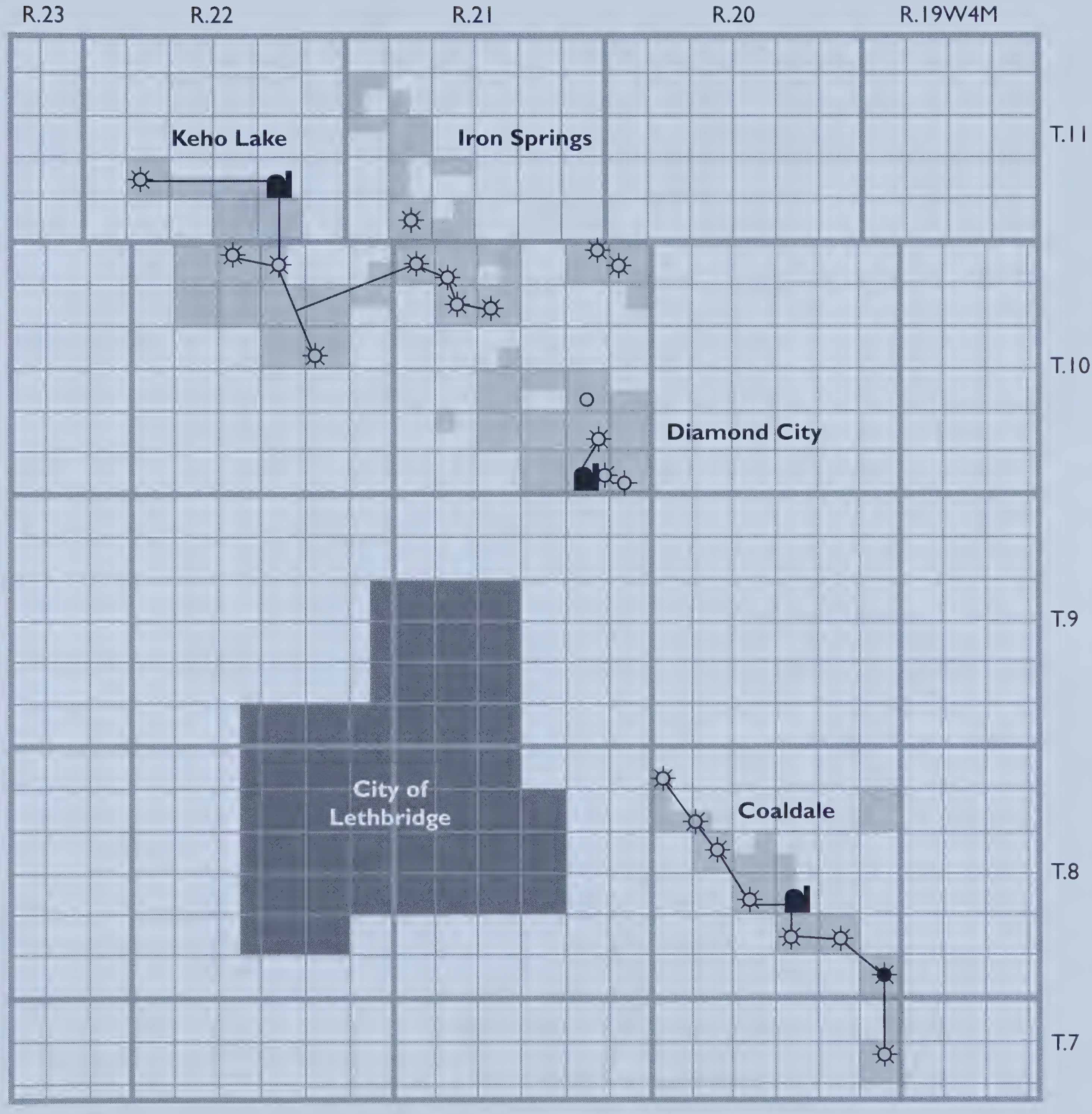
Diamond City

During 1998, Devlan acquired a shut-in Bow Island gas well and 1,897 net acres of land in Diamond City. Subsequently, two step-out wells were drilled for Bow Island production, adding 1.77 Bcf of proven gas reserves in 1998. In February 1999, two of these wells were tied-in.
At the time of this writing, Diamond City sales are 800 mcfd. A third follow-up well is currently being production tested.

Coaldale

This property shows very little decline after 23 years of production from the Bow Island formation. Reserve life is 12 years with total reserves of 1.57 Bcf on December 1, 1998. Sales volumes are 750 mcfd from 7 wells.

Devlan operates two gas plants and related pipelines at Keho Lake and Coaldale. In November 1998, the Company monetized the gas plants and infrastructure for $1.2 million to fund further drilling and development of existing lands. Devlan will continue to operate the plants and facilities thereby keeping control of the area in the Company's hands. Devlan has an option to repurchase the facilities any time over the term.


R.23
R.22
R.21
R.20
R.19W4M
T.11
T.10
T.9
T.8
T.7
Keho Lake
Iron Springs
Diamond City
City of Lethbridge
Coaldale

Prospects

Devlan owns 11,850 acres of land in Converse and Campbell Counties, Wyoming. In February 1998, the Devlan 44-18 Federal well in Converse County was completed at 12,670 feet in the Frontier zone. Due to the sudden downturn in oil prices in early 1998, the well has never been put on pump. However, wellhead pressure has risen to approximately 800 psi at the time of writing. In light of this new development, the Company is re-testing the well and, subject to the test results, production equipment may be installed.

The Wyoming properties are high impact prospects with substantial opportunities. These lands are under long term leases that allow Devlan to dedicate resources when the timing is right. Going forward, the Company will manage the risks associated with these plays in a very sound manner.

Other Company owned oil and liquids-prone prospects include:

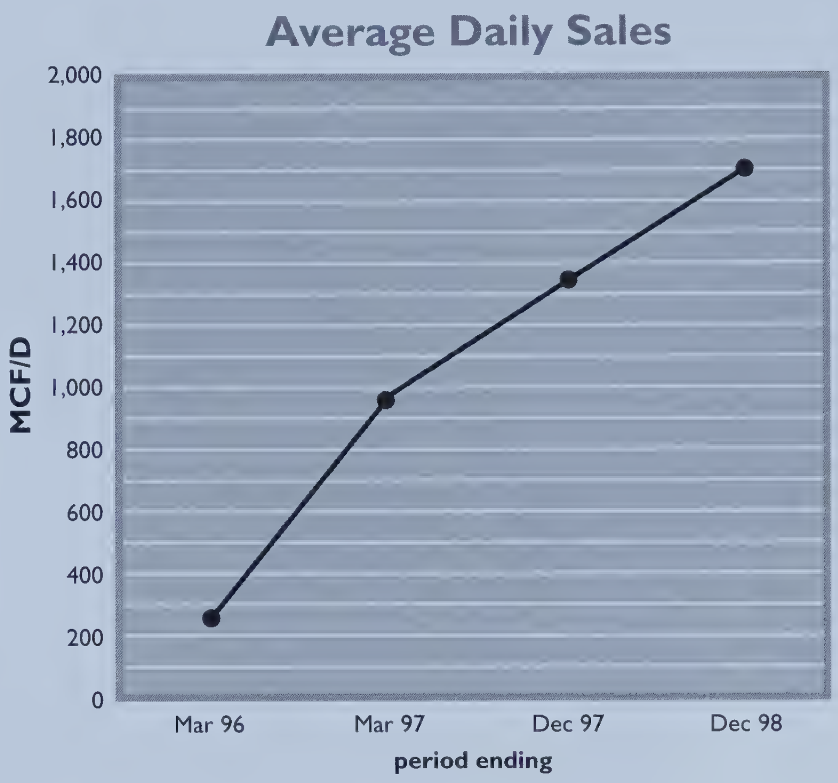
- 4,155 acres at Pinetree in Campbell County, Wyoming with significant bypassed pay in the Frontier zone at 3,200 metres,
- 2,080 acres at Forty Mile Coulee near Taber, Alberta with Sawtooth targets at 950 metres, and;
- 640 acres near Drumheller, Alberta with a Leduc target at 1,800 metres.

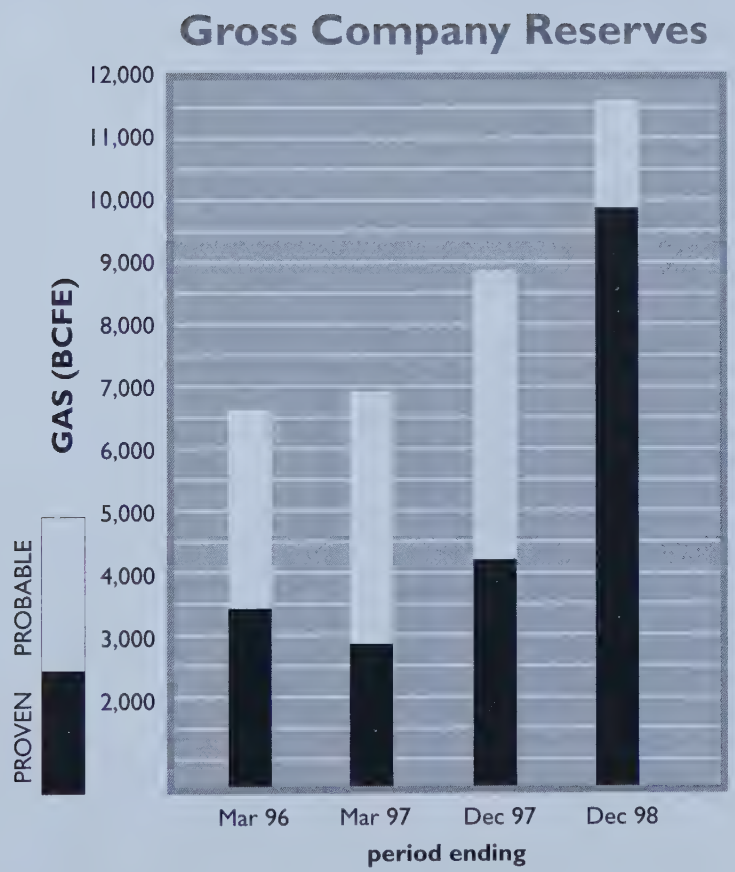
Devlan Properties

Devlan History

1998 average sales 1,700 mcfd - a 26% increase over 1997.

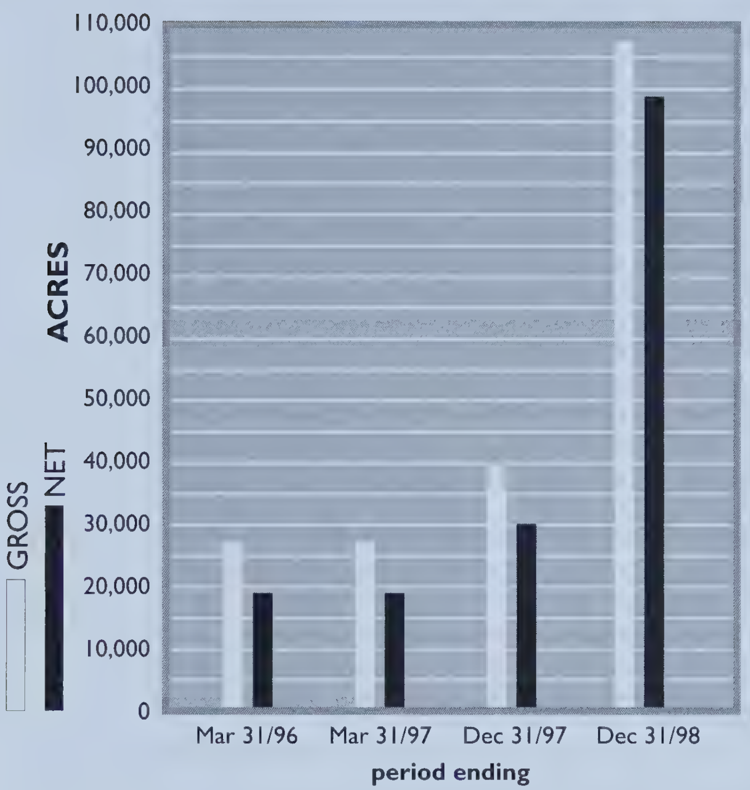
Purchase of Marten Hills in December 1998 - exit sales rate 3,700 mcfd





Reserves increased by 32% to 11.2 Bcfe. Proven reserves account for 85% of total, compared to 44% in 1997.

Land Holdings



Total net land holdings increased by 184% to 97,580 acres.

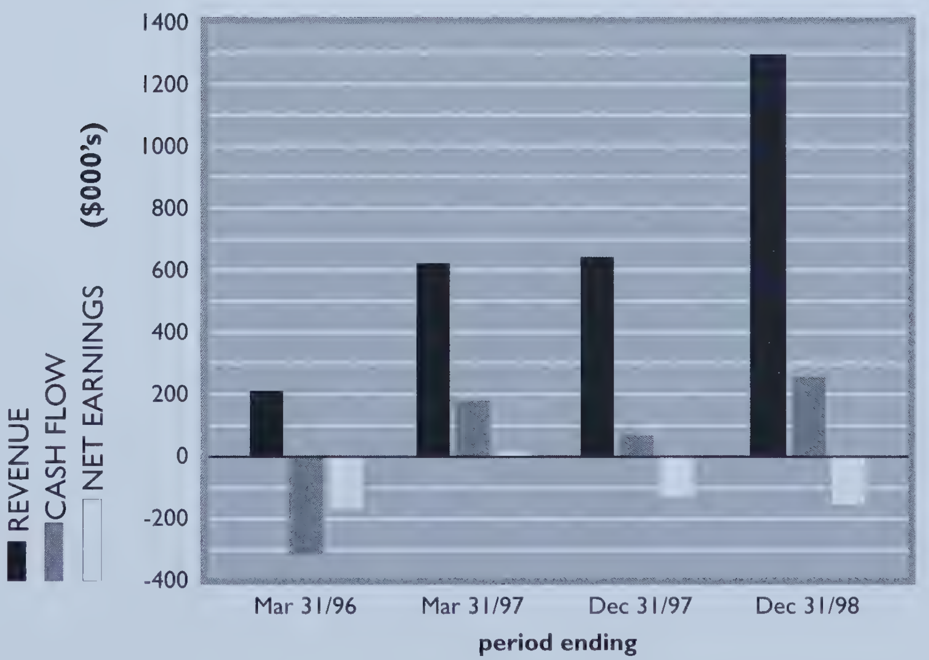
Net undeveloped land increased 3.5 times to 70,635 acres.

Financial Data

Compared to 9 months ended December 31, 1997, Sales Revenue increased 114% to $1.299 million.

Cash Flow increased 335% to $259,400.

Net loss increased 26% to $139,696.



Management's Discussion & Analysis

The following discussion is management's review of Devlan's financial and operating results for 1998 and prior periods. In 1997, the Company's year end was changed to December 31st from March 31st as noted in the Consolidated Financial Statements. For this discussion, comparative values have been prepared internally using a twelve month unaudited period. Estimates of future operating and financial performance are based on available current information and actual results may vary from these estimates.

Revenue:

Sales Income

Sales revenue from natural gas increased by 73% in 1998 to $1,298,917 from $749,155 in the previous twelve-month period. Average daily sales volume increased by 26% from 1,350 mcfd to 1,700 mcfd, with an exit sales volume of 3,700 mcfd. The average sales price at plantgate increased by 34% to C$2.09/mcf compared to C$1.56/mcf in 1997. The average daily sales volume increase was the result of the April 1st Iron Springs acquisition.

Royalties

With the increase in Sales Revenues there was a comparative increase in Royalties to $122,823 in 1998 from $53,619 in 1997. Devlan's 1998 production was not eligible for Alberta Royalty Tax Credits. The new targets at Marten Hills are eligible for Alberta Royalty Tax Credits.

Expenses

Production

1998 operating expenses grew to 36% of oil and gas revenue in 1998 from 32% during the comparable period in 1997. This is attributable, in part, to the Iron Springs acquisition, which resulted in a decrease in the third party charges, maintaining an increased land base from our prospect inventory and their associated costs. As natural gas sales revenues increase through 1999, this percentage will decline. Devlan operated 100 per cent of its production in 1998, which enabled us to maintain control of our asset base.

General and Administrative Expense

Devlan's general and administrative costs increased to $296,891 in 1998 compared to $233,638 for calendar 1997. G&A decreased to 23% of Revenue from 31% during calendar 1997. Included in the expenditures for the year were various expenses associated with Devlan's Private Placements and Shareholder Rights Plan.

Interest Expense on Long Term Debt

The interest expense rose dramatically in 1998 due to the expanded Line of Credit resulting from increased reserve valuations. Devlan also financed both 1998 acquisitions with debt.

Depletion and Depreciation

Devlan's 1998 ceiling test calculation was completed under the full cost method of accounting for petroleum and natural gas properties. Devlan's reserves exceed the carried value of the Company's petroleum and natural gas properties. Therefore no writedown occurred in 1998. Devlan has consistently increased its reserve base year over year.

Net Loss

Devlan's 1998 natural gas operations resulted in a net loss of $139,696 or 3.2¢ per share compared to 1.6¢ per share in the same 12 months of 1997. The loss is directly related to the increased interest expenses related to management's decision to finance acquisitions with debt rather than dilutive equity offerings.

Prepaid Expenses

Devlan has prepaid expenses of $115,866 for year ending December 31, 1998. $94,328 are booked to Marten Hills for 1999 and $21,538 are booked to the Lethbridge facilities monetization.

Bank Debt

Devlan's Total Bank Debt increased by $3.41 million in 1998 as a result of management's decision to fund capital expenditures with debt. The notable equity devaluation in the oil and gas sector in 1998 affected Devlan's equity value as well. Rather than diluting the share capital of the Corporation by issuing undervalued equity, management chose debt. Devlan's capital expenditures delivered significant reserve additions, thereby enabling the Company to expand its line of credit. Management expects to deleverage the Company's position in 1999. Devlan has targeted a 1.8:1 debt to cash flow ratio by year end 1999.

Management's Discussion & Analysis

Advance from Related Party

A corporation which is controlled by certain officers and directors of the Company provided bridge financing for the Marten Hills acquisition. A total of $2,010,000 was loaned to the Company via a demand instrument bearing interest at bank prime plus 2.5% and secured by a floating debenture over the assets of the Company. At the time of this report $700,000 had been repaid.

Capital Lease Obligations

On November 13, 1998 Devlan entered into a sale/leaseback arrangement for facilities consisting of two compressors and related pipelines. The Company received $1.2 million at closing and is obligated to pay monthly processing fees of $21,538 for 60 months. Devlan has the option to repurchase the facilities at any time during the term of the agreement for fair market value. At the end of the term, Devlan may repurchase the facilities for $300,000. Devlan's cost of capital for this transaction is 10.46%

Cash Flow

Cash flow increased to $259,410 a 40% increase over $185,710 in calendar 1997. This can be attributed to higher natural gas prices in 1998 as expenses were relatively commensurate with the elevated sales volumes. Cash flow per share increased by 29% to 5.8¢ from 4.5¢ in calendar 1997.

Capital Expenditures

Devlan's 1998 net capital expenditures totaled $8.482 million, reflecting a very active year, particularly in the last quarter. The significant gross capital expenditures included:

• Iron Springs Acquisition	$ 900,101
• Diamond City Acquisition	$ 197,250
• Diamond City Development	$ 290,209
• Marten Hills Acquisition	$ 5,175,000

These expenditures were funded primarily through debt financing.

Business Risks

As a natural gas producer, Devlan faces a number of business risks associated with exploration and production. These risks include:

- volatility of commodity prices, foreign exchange rates and interest rates;
- economically replacing reserves and annual production;
- the risk of damage to the Company's equipment and the liability associated with an occurrence or malfunction; and
- the environmental impacts from the Company's operations.

Devlan has reduced these risks, to the extent practical, by developing a number of key strategies that include:

- employing highly qualified and motivated management and staff who have a vested interest in Devlan's success;
- balancing exposure to price and rate volatility by applying sound risk management practices;
- focusing on select core areas well understood by management and staff;
- pursuing opportunities that include low-risk development projects, moderate-risk exploration plays and strategic acquisitions;
- maintaining low finding, operating and general and administrative costs;
- maintaining an insurance program to protect against losses due to accidental destruction of assets, well blowouts, pollution and certain business interruptions; and
- maintaining and surpassing compliance with all current environmental legislation and working with government agencies to maintain this level of compliance.

Year 2000 Computer Issue

In the past year the business implications of the "Year 2000" have been the subject of much discussion. The Year 2000 problem is a result of computer programs that were written using two digits rather than four to define the applicable year. Any computer systems that have time sensitive programs may recognize a date using "00" as the year 1900 rather than the year 2000, which could result in miscalculations or a major failure.

The Company has conducted a comprehensive review of its computer programs to identify the programs that could be affected by the Year 2000 issue. Given the Company's current stage of development, its primary use of computers is for word processing, financial and production accounting. The firms responsible for production accounting and land administration have advised Devlan that they have completed their testing and that their programs are Year 2000 compliant.

Management's Discussion & Analysis

The Company has reviewed the impact of the Year 2000 problem on its in house programs, and its computer applications are Year 2000 compliant. Devlan does not anticipate its field operations will be affected because of the limited computer use at this time. All of Devlan's present computer applications have been recently updated and if future applications are to be installed, Devlan will choose programs with a four-digit field to denote the year.

The Company has also initiated a review of its dependence on third parties, including pipeline companies, suppliers and customers. It was determined that the greatest exposure is with respect to the natural gas pipeline system. A failure of a major pipeline due to a Year 2000 problem could have a material adverse effect on the Devlan's operations. The Company has been monitoring the situation and intends on making direct inquires in the second quarter of 1999. Devlan operates all of its properties and as a result will not be adversely affected by any Joint Venture partners.

The Company presently believes that the Year 2000 problem will not pose material operational problems for the Company's computer systems. The expenditures for modifications and conversions are not expected to have a material impact on the operations of the Company. The Company presently believes that there will not be any impediments to implementing required changes to its computer programs.

Management's Report

The accompanying Consolidated Financial Statements, Management's Discussion and Analysis of Financial Condition and Review of Operations and all other information presented in the Annual Report is the responsibility of the Company's management. The Management's Discussion and Analysis of Financial Condition and Operating Results is reflective of management's views of the industry environment, current and future trends, and their effect on the Company's December 31, 1998 Financial Statements and future results.

The Consolidated Financial Statements have been prepared by management in accordance with accounting principles generally accepted in Canada. The Company's internal controls have been designed and maintained by management to provide reasonable assurance that assets are properly safeguarded, and that the financial records are sufficiently well-maintained to provide relevant, timely and reliable information to management and to allow preparation of the Consolidated Financial Statements in accordance with the Company's accounting policies. Certain estimates are made by the management in the preparation of the Consolidated Financial Statements. In the opinion of management, the Consolidated Financial Statements have been prepared within reasonable limits of materiality, and within the framework of the significant accounting policies as summarized in the Notes to the Consolidated Financial Statements.

Deloitte & Touche, an independent firm of chartered accountants, have been appointed by the Shareholders to examine the Consolidated Financial Statements and to report to the Shareholders. The Audit Committee, consisting of non-management directors, has reviewed the Consolidated Financial Statements with management to determine if management has fulfilled its responsibilities for the preparation of the Consolidated Financial Statements. The Audit Committee has reported its findings to the Board of Directors, who have approved the Consolidated Financial Statements.

Martin J. Cheyne
President and
Chief Executive Officer

Wm. M. Matheson
Vice President
Corporate Development
and Chief Financial Officer

Auditors' Report

December 31, 1998 and 1997

To the Shareholders of
Devlan Exploration Inc.:

We have audited the consolidated balance sheets of Devlan Exploration Inc. as at December 31, 1998 and 1997 and the consolidated statements of loss and deficit and changes in financial position for the year ended December 31, 1998 and the nine month period ended December 31, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and 1997 and the results of its operations and the changes in its financial position for the year ended December 31, 1998 and the nine month period ended December 31, 1997 in accordance with generally accepted accounting principles.

Deloitte & Touche LLP

Calgary, Alberta
March 5, 1999

Chartered Accountants

Consolidated Statements of Loss and Deficit

Year Ended December 31, 1998 and
Nine Month Period Ended December 31, 1997

	December 31, 1998 (12 months)	December 31, 1997 (9 months)
REVENUE		
Production revenue	$ 1,298,917	$ 606,409
Royalty expense	(122,823)	(56,771)
	1,176,094	549,638
EXPENSES		
Operating	469,145	258,090
General and administrative	296,891	210,318
Interest and bank charges	150,645	21,591
Depletion and amortization	399,109	170,783
	1,315,790	660,782
NET LOSS	(139,696)	(111,144)
DEFICIT, BEGINNING OF YEAR	(1,123,762)	(1,012,618)
DEFICIT, END OF YEAR	$ (1,263,458)	$ (1,123,762)
Loss per share (Note 8)	(0.03)	(0.03)

Consolidated Balance Sheets

December 31, 1998 and 1997

	1998	1997
ASSETS		
CURRENT		
Cash	$ 3,123	$ —
Accounts receivable	246,720	325,419
Prepaid expenses	115,866	—
	365,709	325,419
Petroleum and natural gas properties and facilities (Note 2)	11,120,743	3,470,634
	$ 11,486,452	$ 3,796,053
LIABILITIES		
CURRENT		
Cheques issued in excess of funds on deposit	—	52,951
Accounts payable and accrued liabilities	594,428	221,833
Current portion of long-term debt (Note 3)	1,760,000	300,000
Current portion of obligation under capital lease (Note 4)	145,025	—
Debenture payable (Note 5)	—	50,000
Advance from related party (Note 6)	2,010,000	—
	4,509,453	624,784
Long-term debt (Note 3)	2,500,000	550,000
Obligation under capital lease (Note 4)	1,030,081	—
Deferred revenue	228,089	—
Future site restoration and abandonment costs	91,698	64,124
	8,359,321	1,238,908
SHAREHOLDERS' EQUITY		
Share capital (Note 7)	4,390,589	3,680,907
Deficit	(1,263,458)	(1,123,762)
	3,127,131	2,557,145
	$ 11,486,452	$ 3,796,053

APPROVED BY THE BOARD

Director ______________________ Director ______________________

Consolidated Statements of Changes in Financial Position

Year Ended December 31, 1998 and
Nine Month Period Ended December 31, 1997

	December 31, 1998 (12 months)	December 31, 1997 (9 months)
NET INFLOW (OUTFLOW) OF CASH RELATED TO THE FOLLOWING ACTIVITIES		
OPERATING		
Net loss	**$ (139,696)**	$ (111,144)
Items not affecting cash		
Depletion and amortization	**399,109**	170,783
Gain on settlement of debt	**—**	(17,069)
	259,413	42,570
Changes in non-cash operating working capital items	**335,428**	(454,236)
	594,841	(411,666)
FINANCING		
Proceeds from issuance of common shares	**709,682**	1,029,841
Increase in long-term debt	**3,410,000**	850,000
Increase (decrease) in advances from related party	**2,010,000**	(850,000)
Repayment of debenture payable	**(50,000)**	—
Proceeds from obligation under capital leases	**1,200,000**	—
Repayment of obligation under capital leases	**(24,894)**	—
Deferred revenue	**228,089**	—
	7,482,877	1,029,841
INVESTING		
Purchase of petroleum and natural gas properties	**(8,481,644)**	(653,472)
Proceeds from disposal of petroleum and natural gas properties	**460,000**	—
	(8,021,644)	(653,472)
NET CASH INFLOW (OUTFLOW)	**56,074**	(35,297)
CASH POSITION, BEGINNING OF YEAR	**(52,951)**	(17,654)
CASH POSITION, END OF YEAR	**$ 3,123**	$ (52,951)

Notes to the Consolidated Financial Statements

Year Ended December 31, 1998 and
Nine Month Period Ended December 31, 1997

1. SIGNIFICANT ACCOUNTING POLICIES

Change of financial year end

On December 2, 1997, the shareholders approved the change in the Company's financial year end from March 31 to December 31 commencing in 1997. This has resulted in a nine-month comparative financial reporting period from April 1, 1997 to December 31, 1997

Petroleum and natural gas properties and facilities

The Company follows the full cost method of accounting for petroleum and natural gas operations, whereby all costs relating to the exploration and development of petroleum and natural gas reserves are capitalized on a country-by-country cost centre basis. Such costs include land acquisition costs, costs of drilling both productive and non-productive wells, well equipment, flowline and plant costs, geological and geophysical expenses and overhead expenses directly related to exploration and development activities.

Gains or losses on sales of properties are recognized only when crediting the proceeds to the recorded costs would result in a change of 20% or more in the depletion and depreciation rate.

Capitalized costs are depleted using the unit-of-production method based on estimated proven reserves of petroleum and natural gas before royalties as determined by independent petroleum engineers. Proven natural gas reserves and production are converted to equivalent volumes of crude petroleum based on the approximate relative price ratio of 10 mcf of natural gas to one barrel of crude oil.

Petroleum and natural gas properties and facilities

The net book value of the Company's petroleum and natural gas properties and equipment is subject to the cost recovery test ('ceiling test'). The Company estimates the future net revenues, using year end prices, plus the lower of cost and estimated fair value of unproven properties, less future site restoration and abandonment costs, general and administrative expenses, financing costs and income taxes. Any deficiency in the future recoverable costs as compared to the net book value is charged to current operations as part of depletion and amortization expense.

Future site restoration and abandonment costs

Estimated future removal and site restoration costs are provided for on the basis of costs divided by the estimated economic life of the estimated proven reserves. Costs are estimated each year by management in consultation with the Company's independent petroleum engineers based on current regulations, costs, technology and industry standards. The annual charge is included in depletion and amortization expense, and actual removal and site restoration expenditures are charged to the accumulated provision account as incurred.

Joint ventures

Substantially, all of the Company's exploration and development activities are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

Flow-through shares

Share capital includes flow-through shares issued pursuant to certain provisions of the Income Tax Act (Canada). Under the Act, where the proceeds are used for eligible expenditures, the related income tax deductions may be renounced to subscribers. Both share capital and petroleum and natural gas properties are reduced by an amount equal to the estimated future income taxes payable by the Company as a result of the renunciations.

Hedging

The Company periodically enters into forward contracts to reduce its exposure to price fluctuations on a portion of its natural gas production. The contracts are not used for speculative trading purposes. Gains or losses on these contracts are reported as adjustments to natural gas revenue in the related production month.

Deferred Revenue

Deferred revenue is comprised of the gain on the sale and leaseback of a gas plant during the current year. This gain will be recognized into income over the estimated life of the gas plant.

2. PETROLEUM AND NATURAL GAS PROPERTIES AND FACILITIES

		December 31, 1998	
	Cost	Accumulated Depletion and Amortization	**Net Book Value**
Canada			
Petroleum and natural gas properties and facilities	$ 9,113,216	748,625	**8,364,591**
Gas plant facility under capital lease	1,200,000	—	**1,200,000**
United States			
Petroleum and natural gas properties and facilities	1,556,152	—	**1,556,152**
	$ 11,869,368	748,625	**11,120,743**

		December 31, 1997	
	Cost	Accumulated Depletion and Amortization	**Net Book Value**
Canada			
Petroleum and natural gas properties and facilities	$ 2,880,052	349,516	**2,530,536**
United States			
Petroleum and natural gas properties and facilities	940,098	—	**940,098**
	$ 3,820,150	349,516	**3,470,634**

The capitalized overhead expense is $99,912 for the year ended December 31, 1998 (1997 - $Nil).

Notes Continued

3. LONG-TERM DEBT

	1998	1997
The Company has an available bank credit facility for up to $3,500,000. Amounts outstanding bear interest at bank prime plus 1%, are secured by a general security agreement and fixed and floating charge debenture over all the assets of the Company and are repayable in monthly instalments of $120,000 commencing February 1, 1999	**$ 3,060,000**	$ 850,000
Term loan bearing interest at bank prime plus 2%, secured by a general security agreement and fixed and floating debenture over all the assets of the Company, repayable in monthly instalments of $40,000 commencing February 1, 1999	**1,200,000**	—
	4,260,000	850,000
Less current portion	**1,760,000**	300,000
	$ 2,500,000	$ 550,000

Interest on long-term debt amounted to $92,126 (1997 - $8,911).

The aggregate principal payments required to meet these obligations in each of the next three years are as follows:

1999	**$ 1,760,000**
2000	**$ 1,920,000**
2001	**$ 580,000**

4. OBLIGATION UNDER CAPITAL LEASE

The aggregate future minimum lease payments required to meet the obligation under capital lease are as follows:

Year ending December 31, 1999	**$ 258,456**
2000	**258,456**
2001	**258,456**
2002	**258,456**
2003	**529,048**
Total minimum lease payments	**1,562,872**
Less interest implicit in lease (11%)	**387,766**
	1,175,106
Less current portion	**145,025**
	$ 1,030,081

5. DEBENTURE PAYABLE

The debenture payable of $50,000 bore interest at the bank prime rate with certain assets pledged as security. The debenture was redeemable at any time at the option of the Company at a price equal to the principal amount outstanding and was convertible at any time into common shares of the Company at a rate of $0.65 for each common share to be issued. The debenture was repaid during the year.

6. ADVANCE FROM RELATED PARTY

The advance from a related party is due on demand and bears interest at bank prime plus 2.5%, and is secured by a floating charge debenture over the assets of the Company, second to the bank's security.

7. SHARE CAPITAL

	Number of Shares	**Amount**
Authorized		
Unlimited number of common shares		
Unlimited number of first preferred shares		
Unlimited number of second preferred shares		
Issued		
Common shares		
Balance, March 31, 1997	$ 3,611,157	**$ 2,651,066**
Exercise of stock options	348,250	**271,635**
Private placement	72,931	**204,206**
Conversion of debt (Note 7(d))	357,143	**554,000**
Balance, December 31, 1997	4,389,481	**3,680,907**
Private placement	104,088	**124,900**
Private placement flow-through common shares (net of tax incentives renounced of $410,554)	995,336	**584,782**
Balance December 31, 1998	$ 5,488,905	**$ 4,390,589**

a) On October 16, 1998 the Company received shareholder approval to consolidate the common shares of the Company on a one-for-four basis. The number of common shares has been retroactively restated to reflect this consolidation.

b) Stock options

At December 31, 1998, the Company has granted to directors and officers options, expiring June 26, 2002, to purchase a total of 375,000 common shares at $0.82 per share.

Notes Continued

7. SHARE CAPITAL (continued)

c) Warrants

As part of a private placement, effective July 2, 1997, the Company issued 145,862 warrants to purchase common shares at an exercise price of $0.70 by May 1, 1998. None of these warrants were exercised.

d) Conversion of debt

Effective September 19, 1997, the advances from related parties, as well as other accrued interest and current accounts payable, amounting to $1,000,000, were converted into a total of 1,428,571 pre-consolidated common shares at $0.70 per common share. As part of the debt conversion, the common shares issued were flow-through shares, such that the Company has renounced to the subscriber, a total of $1,000,000 in Canadian Development Expense, and accordingly, the share capital and petroleum and natural gas properties and facilities have been reduced by $446,000.

8. LOSS PER SHARE

The loss per share is calculated using the weighted average number of shares outstanding during the period. Fully diluted loss per share is not presented because of its anti-dilutive nature.

9. INCOME TAXES

The Company has approximately $1,500,000 (1997 - $1,300,000) of non-capital losses available to reduce future years' income for income tax purposes. These losses expire from time to time after 2000. The benefit of these losses have not been recognized in the financial statements.

10. RELATED PARTY TRANSACTIONS

Included in accounts payable and accrued liabilities is $Nil (1997 - $65,416) due to corporations which are controlled by officers and directors of the Company.

11. FINANCIAL INSTRUMENTS

The carrying amounts of the Company's financial assets and liabilities approximate their fair value. The Company is exposed to credit risk to the extent that its operators may experience financial difficulty and would be unable to meet their obligations. However, the diversity of the Company's joint venture partners minimizes concentration of credit risk.

The Company enters into natural gas contracts for hedging purposes in order to protect its cash flow on future sales from the potential adverse impact of low natural gas prices. The contracts reduce the fluctuation in sale revenue by locking in fixed prices and exchange rates on a portion of its natural gas. The notional quantity of natural gas of 26,200 gigajoules per month is forward sold, with an average price of $2.16 per gigajoule referenced to AECO. Based on current market prices at December 31, 1998 the unrealized gain from these contracts would be $58,328. The contracts are due to expire on March 31, 1999 and April 1, 2000.

12. SEGMENTED INFORMATION

Year ended December 31, 1998

	Canada	U.S.	**Total**
Revenue	$ 1,176,094	$ —	**$1,176,094**
Depreciation and amortization	399,109	—	**399,109**
Operating costs	469,145	—	**469,145**
Segment operation profit	$ 307,840	$ —	**$ 307,840**
Interest and bank charges			**150,645**
Corporate expenses			**296,891**
Net loss			**$ 139,696**
Identifiable assets	$ 9,930,300	$ 1,556,152	**11,486,452**
Capital expenditures	$ 7,865,590	$ 616,054	**$8,481,644**

Nine month period ended December 31, 1997

	Canada	U.S.	**Total**
Revenue	$ 549,638	$ —	**$ 549,638**
Depreciation and amortization	170,783	—	**170,783**
Operating costs	258,090	—	**258,090**
Segment operation profit	120,765	—	**120,765**
Interest and bank charges			**21,591**
Corporate expenses			**210,318**
Net loss			**$ 111,144**
Identifiable assets	$ 2,855,955	$ 940,098	**$3,796,053**
Capital expenditures	$ 653,472	$ —	**$ 653,472**

Notes (Continued)

13. UNCERTAINTY DUE TO THE YEAR 2000 ISSUE

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using the year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the Company, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

14. SUBSEQUENT EVENT

Effective February 24, 1999, the Company entered into an agreement to sell a gas plant facility for cash consideration of $3,000,000. The Company is to receive $2,000,000 upon closing and $1,000,000 when it completes the Marten Hills development.

Directors & Officers

Board of Directors

Roy J. Barr, C.A.
Calgary, Alberta
Senior Partner
Barr Shelley Stuart

Martin J. Cheyne
Calgary, Alberta
President & Chief Executive Officer
Devlan Exploration Inc.

Gary J. Cochrane, L.L.B.
Calgary, Alberta
Partner
Fraser Milner

Bradley B. Porter
Calgary, Alberta
Executive Vice President &
Chief Operating Officer
Devlan Exploration Inc.

Lyle J. Reinhart
Calgary, Alberta
President
Bowhart Holdings Ltd.

Officers and Key Personnel

Martin J. Cheyne
President & Chief Executive Officer

Bradley B. Porter
Executive Vice President &
Chief Operating Officer

William M. Matheson
Vice-President Corporate Development &
Chief Financial Officer

Scott L. Patterson
Vice-President Exploration

Executive Offices

520, 520 - 5th Avenue SW
Calgary, Alberta T2P 3R7

Telephone (403) 233-7778
Fax (403) 261-3808

Website: www.devlanx.com
Email: admin@devlanx.com

Stock Listing
Alberta Stock Exchange
Trading Symbol "DXI"

Registrar and Transfer Agent
Montreal Trust
600, 530 - 8th Avenue SW
Calgary, Alberta T2P 3X2

Legal Counsel
Blake, Cassels & Graydon
3500, 855 - 2nd Street SW
Calgary, Alberta T2P 4J8

Bankers
Canadian Western Bank
606 - 4th Street SW
Calgary, Alberta T2P 1T1

Auditors
Deloitte & Touche
2400, 700 - 2nd Street SW
Calgary, Alberta T2P 0S7

DEVLAN
EXPLORATION INC.

520, 520 - 5th Avenue SW
Calgary, Alberta, Canada T2P 3R7

Tel: (403) 233-7778
Fax: (403) 261-3808
Website: www.devlanx.com
Email: admin@devlanx.com

Production
Devlan Exploration Inc.

Design
Two Birds, One Stone Design